

**BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA**



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Application of California-American Water Company (U 210 W) for an Interest Rate of 8.33% for Allowance for Funds Used During Construction (AFUDC) for its San Clemente Dam Memorandum Account.

Application No. 07-02-023
(Filed February 20, 2007)

CALIFORNIA-AMERICAN WATER COMPANY'S CONCLUDING BRIEF

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CALIFORNIA-AMERICAN WATER COMPANY'S CONCLUDING BRIEF

In accordance with Rule 13.11 of the Rules of Practice and Procedure of the California Public Utilities Commission ("Commission") and the *Scoping Memo and Ruling of Assigned Commissioner and Administrative Law Judge*,¹ California-American Water Company ("California American Water") respectfully submits its Concluding Brief in the above-referenced proceeding. California American Water hereby responds to the Reply Brief of the Division of Ratepayer Advocates ("DRA Brief") and the Reply Brief of the Monterey Peninsula Water Management District ("MPWMD Brief"), both filed on September 7, 2007.

This Concluding Brief demonstrates the following:

- No party has refuted affirmative evidence in this proceeding that setting the AFUDC rate below California American Water's authorized cost of capital will impair California American Water's ability to earn a reasonable rate of return for the Monterey District, which will ultimately harm all California American Water customers by increasing capital costs.
 - The record demonstrates that California American Water's authorized rate of return is appropriate for the AFUDC rate because it is a reasonable estimate of the lower range of the ongoing cost to finance the San Clemente Dam Project development and construction.
- DRA's and MPWMD's contentions that the 90-day commercial paper rate will adequately

¹ *Scoping Memo and Ruling of Assigned Commissioner and Administrative Law Judge Determining the Scope, Schedule, and Need for Hearing in This Proceeding*, issued on May 18, 2007, p. 4.

compensate California American Water for its San Clemente Dam Project investment are contradicted by evidence that California American Water cannot rely upon short-term financing to cover the carrying costs related to the San Clemente Dam. Notably, neither DRA nor MPWMD contend that an investor would agree to pay for this much-needed project in return for a 90-day commercial paper rate, subject to later reasonableness review.

- The Commission should give no weight to unsubstantiated claims that customers will benefit from proposals to discount the carrying cost for the San Clemente Dam Project. DRA's and MPWMD's proposals to shortchange the carrying costs for the San Clemente Dam Project are short-sighted and will ultimately harm California American Water and its customers.
- The Commission must not impose a de facto disallowance of California American Water's carrying costs by prejudging the AFUDC interest before the reasonableness review has taken place. MPWMD's and DRA's proposal to discount the AFUDC rate because of the asserted risk that customers may not receive the benefits of expenditures on the San Clemente Dam Project would violate the principles in *Hope* and *Bluefield*.² Discounting the AFUDC rate would violate the principles of *Hope* and *Bluefield* that a utility is entitled to the opportunity to earn a return on investment that is commensurate with the risks, since the resulting shortfall cannot later be made up in a reasonableness review even if every dollar spent on the project is found prudent.
- California American Water's proposal to set the San Clemente Dam Project AFUDC rate at its currently authorized cost of capital is rooted in Commission precedent and Commission caselaw supports its approval. Prior Commission decisions allowing water utilities to accrue capitalized interest based upon a short-term borrowing rate for short-term deferred items are not applicable to the San Clemente Dam Project because the project financing is neither short-term nor low risk.

² *Federal Power Comm'n v. Hope Natural Gas Company*, 320 U.S. 591 (1944) ("*Hope*"); *Bluefield Water Works & Improvement Co. v. West Virginia Public Service Comm'n*, 262 U.S. 679 (1923) ("*Bluefield*").

- Consistent with the Commission's policy objectives in the Water Action Plan to support water infrastructure investments, the Commission should support California American Water's efforts to mitigate and minimize the effects of potential earthquake and flooding events to residents living downstream of the old earthen San Clemente Dam along the Carmel River. Public safety is a key Commission priority, as it should be.

I. THE COMMISSION SHOULD SET CALIFORNIA AMERICAN WATER'S AFUDC RATE AT ITS CURRENTLY AUTHORIZED RATE OF RETURN

A. The Evidence Shows that Setting the AFUDC Rate Below Its Current Cost of Capital Will Impair California American Water's Ability to Earn a Reasonable Rate of Return, and Harm Customers.

Setting the AFUDC rate below California American Water's current cost of capital will impair California American Water's ability to earn a reasonable rate of return, which will ultimately harm customers by increasing capital costs and making it more difficult for California American Water to attract capital. In claiming that such harms are speculative, DRA and MPWMD ignore evidence of the harmful impact such a discount will cause to California American Water's earnings for the Monterey District. Most notably, DRA and MPWMD do not address the projected **\$4.6 million effect** its proposal will have on net income over a four-year construction period,³ as well as the resulting reductions to California American Water's return on equity, that will result if the Commission does not authorize an adequate AFUDC rate of at least its current cost of capital.⁴ DRA and MPWMD need only review the record to see the devastating financial impact that would result, as California American Water's return on equity is projected to drop **from 9.39 percent in 2007 to 6.72 percent in 2010.**⁵

This unrefuted evidence affirms that failing to set the AFUDC at a proper level will harm California American Water's financial condition, which will increase the cost of

³ This projection is based upon assumptions of a short-term interest rate of 5.2% and California American Water's authorized rate of return of 8.33%.

⁴ See California American Water's Opening Brief, pp. 11-12.

⁵ See California American Water's Opening Brief, pp. 11-12.

capital paid by all of California American Water's customers and ultimately make it difficult or impossible to obtain if the situation continues. Such deteriorating impacts on California American Water's financial health will have potentially severe consequences for customers at just the time when substantial capital investments will be required for their benefit. Contrary to MPWMD's and DRA's unsupported claims, these harms are very real and supported by the evidence.

MPWMD contends that these earnings impacts will not affect California American Water because it is well-funded through its affiliate American Water Capital Corporation and does not "need to compete in outside financial markets."⁶ This is incorrect, as the mere existence of a holding company does not repeal basic principles of finance. American Water Capital Corporation, the entity issuing the debt and equity, must maintain its credit rating in order to preserve its access to capital. While California American Water and its customers currently benefit from ready access to capital from American Water Capital Corporation, the credit rating of American Water Capital Corporation cannot be sustained if each of American Water Works Company, Inc.'s ("American Water") subsidiaries does not provide support for the credit rating. Furthermore, denying California American Water the opportunity to recover the cost of its investments will encourage American Water (under principles of prudent financial management) to provide capital to other subsidiaries instead.

Practically speaking, the position of MPWMD and DRA pressures California American Water not to make this much-needed investment. If the Company goes ahead, they effectively assert, it should do so with a guarantee of a substantial shortfall, which will place the utility in financial jeopardy. After that harm is imposed, further jeopardy may occur through reasonableness review if these parties then seek disallowances. The final, unbelievable assertion is that such terms should have no effect on the willingness or ability of investors to advance capital.

⁶ MPWMD Brief, p. 9.

DRA's contention that the Commission's authorization of the proposed transfer of indirect control of California American Water by RWE Aktiengesellschaft's ("RWE") sale of American Water through one or more public offerings somehow justifies setting the San Clemente Dam Project AFUDC rate below the current cost of California American Water's capital is senseless.⁷ American Water's (the parent of California American Water) ability to access the public capital markets will not change the fact that investors will not provide funds for less than a compensatory return. Notably, neither DRA nor MPWMD contend that an investor would agree to pay for this much-needed project in return for a 90-day commercial paper rate, subject to later reasonableness review. Rather, they suggest that investors should be forced to accept the short-fall between the 90-day commercial paper and the actual carrying costs. The Commission should reject DRA's and MPWMD's unwarranted proposal.

B. The Commission's Fundamental Obligation to Investors is at Issue Here.

Setting the AFUDC rate at California American Water's authorized cost of capital is necessary for California American Water to have the opportunity to earn a compensatory rate of return on its investment and recover its operating costs. It is important to note that California American Water is only seeking the opportunity to earn a compensatory rate of return on its investment and recover its operating costs. That opportunity lies at the heart of the Commission's compact with investors. California American Water is not seeking a higher return

⁷ The Proposed Transaction authorized by the Commission in D.07-05-031 involves the transfer of control of American Water from a sole owner to a public ownership. The Proposed Transaction includes the sale by Thames Water Aqua Holdings GmbH ("Thames GmbH") of up to 100% of the shares of common stock of American Water by Thames GmbH in one or more public offerings. (D.07-05-031, *In re Application of California- American Water Company (U-210-W), a California Corporation, RWE Aktiengesellschaft, a Corporation Organized Under the Laws of the Federal Republic of Germany, Thames Water Aqua Holdings GmbH, a Corporation Organized Under the Laws of the Federal Republic of Germany, and American Water Works Company, Inc. for an Order Authorizing the Sale by Thames GmbH of up to 100% of the Common Stock of American Water Works Company, Resulting in a Change of Control of California-American Water Company and For Such Related Relief as May be Necessary to Effectuate Such Transaction*, 2007 Cal. PUC LEXIS 140 (2007).

for the San Clemente Dam Project than the cost of capital it is currently authorized to earn for its other investments.⁸

1. California American Water's authorized rate of return is a reasonable estimate of the ongoing cost to finance the San Clemente Dam Project development and construction.

The record demonstrates that California American Water's authorized rate of return is appropriate for the AFUDC rate because it is a reasonable estimate of the **lower** range of the ongoing cost to finance the San Clemente Dam Project development and construction. DRA and MPWMD provide no evidence supporting their vague contentions that California American Water will be overcompensated if the AFUDC rate is set at California American Water's authorized cost of capital.

First, California American Water has demonstrated that for a number of reasons its carrying cost for the San Clemente Dam Project would undoubtedly be higher than the authorized cost of capital if the Project was financed as a stand-alone investment. As set forth in California American Water's Opening Brief, due to the long-term nature of the project as well as the risks associated with the San Clemente Dam Project, the Project will require a higher rate of return than California American Water's weighted average cost of capital. As set forth in the Declaration of Dr. Carl Danner in Support of California American Water's Opening Brief, finance theory dictates that if an investment is less risky, the investor expects a lower return, and if an investment is more risky, the investor expects a higher return. Here, the fact that the remediation investment has not yet been reviewed for reasonableness, along with the potential

⁸ California American Water does not object to setting the AFUDC rate at the most recent cost of capital authorized by the Commission. See D.07-08-030 *In re Application of California-American Water Company (U 210 W) for an Order Authorizing it to Increase its Rates for Water Service in its Los Angeles District to Increase Revenues by \$2,020,466 or 10.88% in the Year 2007; \$634,659 or 3.08% in the Year 2008; and \$666,422 or 3.14% in the Year 2009*, p. 2. As set forth in California American Water's Opening Brief, even though it would be most accurate to adopt an AFUDC rate that reflects the actual carrying cost of the San Clemente Dam Project, California American Water is only seeking to earn the same overall rate of return on the accumulated San Clemente Dam Project costs as it has been allowed by this Commission for its other investments. California American Water's Opening Brief, pp. 6-7.

for disallowances, makes the investment more risky than California American Water's overall investment in rate base, and thus, the carrying cost for the remediation investment will be higher.

Although its claims about the Project are largely exaggerated, MPWMD admits that the San Clemente Dam Project is a high-cost project, will require long-term financing and carries a higher level of risk than California American Water's other investments.⁹ While general principles of finance theory indicate that this type of investment requires a higher return, MPWMD suggests that utility shareholders should be required to pay for the shortfall between that actual cost and a low return that is obviously unsuitable to the situation.

Second, California American Water provided evidence that even if recovery of the carrying cost is allowed at the full rate of return, California American Water will still be under-recovering its total costs due to depreciation expense. Portions of the San Clemente Dam Project, which are already used and useful, are being depreciated and are being tracked in the memorandum account recovering only carrying costs at 90-day commercial paper with no recovery of depreciation expense.¹⁰

MPWMD's suggestion that California American Water's investment and operating expenses cannot be used and useful until the permitting agencies certify the "environmental documentation" is belied by the facts. MPWMD admits that customers are already benefiting from some of the San Clemente Dam improvements, including "drilled ports, annual drawdowns, and security alarm system costs."¹¹ This is not surprising, as California American Water undertook numerous studies of the dam strengthening option and alternatives, which included extensive sediment transport modeling, seismic safety design and environmental studies, as well as a number of improvements. A description of these improvements is set forth in the Declaration of F. Mark Schubert, P.E., attached hereto as Exhibit A.

⁹ MPWMD Brief, p. 5.

¹⁰ California American Water Opening Brief, p. 3.

¹¹ MPWMD Brief, p. 7.

Third, contrary to MPWMD's and DRA's contentions, California American Water cannot and will not be overcompensated by setting the AFUDC rate at its currently authorized cost of capital. California American Water's recovery of any costs will be subject to reasonableness review and will provide adequate safeguards to prevent California American Water from over-recovering on its San Clemente Dam Project. Reasonableness review will give these parties their proverbial "bite at the apple" with regard to the entirety of this investment.

MPWMD's claim that California American Water has historically overearned on its authorized return on equity is meritless. MPWMD's contentions regarding California American Water's authorized cost of capital are inappropriate because they are outside the scope of this proceeding and are not being litigated here and in fact, are erroneous.¹²

2. The 90-day commercial paper rate is inadequate to compensate California American Water for its actual carrying costs.

DRA's and MPWMD's vague contentions that the 90-day commercial paper rate will adequately compensate California American Water for its San Clemente Dam Project investment are contradicted by the evidence. California American Water cannot rely upon short-term financing to cover the carrying costs related to the San Clemente Dam. California American Water will be required to issue new debt and equity to finance all of its capital needs, including those for the San Clemente Dam Project, and as such, short-term debt will be inadequate to fund the project. Without any supporting evidence, DRA contends that California American Water can simply cover its carrying costs from "ongoing operations or financed with

¹² MPWMD refers to D.04-05-023, which discussed California American Water's history of overearning. MPWMD fails to note, however, that the overearning referred to in that decision was mainly due to being allowed to collect deferred balancing account balances. Nor does MPWMD provide citations to any more recent data. The Commission should give no weight to MPWMD's improper reference to stale data from a previous decision to imply that California American Water regularly overearns. (D.04-05-023, *In re Application of the California-American Water Company (U210W) for an Order Authorizing it to Increase its Rates for Water Service in its Sacramento District to Increase Revenues by \$ 8,198,700 in the Year 2003; and \$ 1,955,000 in the Year 2004 and Related Matters*, 2004 Cal. PUC LEXIS 234 (2004)).

short-term borrowings.”¹³ It would be imprudent and unreasonable for California American Water to rely upon short-term financing to cover the carrying costs related to the San Clemente Dam Project, a project which DRA and MPWMD both admit will require long-term financing. DRA’s and MPWMD’s proposed 90-day commercial paper rate is typically paid by capital markets for a short-term investment of very low risk. Here, California American Water’s seismic safety investment is neither short-term nor low risk. As set forth in the Declaration of David P. Stephenson, attached hereto as Exhibit B. California American Water has a large capital investment program, including such major projects as the Coastal Water Project in Monterey, retrofitting of the San Clemente Dam in Monterey and installation of meters in Sacramento. Any short-term debt that is used as an interim measure to finance capital projects must be refinanced annually with long-term debt and equity. Furthermore, due to the large balances that California American Water carries in its balancing accounts, memorandum accounts and other deferred items, California American Water may not be able to meet these needs, much less capital expenditures, through its average annual short-term borrowings.

DRA and MPWMD provide no evidence that supports their claim that the 90-day commercial paper rate is adequate to cover the San Clemente Dam Project’s carrying costs. DRA contends only that the investment community is already aware of the increased risks associated with the San Clemente Dam Project and the stock price of California American Water’s parent company (American Water) should reflect “the expected level of recovery for the project costs.”¹⁴ DRA is correct that the under-recovery of carrying costs will impact a utility’s

¹³ DRA Brief, p. 3.

¹⁴ DRA Brief, p. 4. Curiously, this position is contrary to the position take by DRA in California American Water’s Los Angeles District general rate case (A.06-01-005), in which it contended that the Commission should make a downward adjustment to the utility’s Return on Equity. In that proceeding, DRA argued that water utilities differ from competitive industries in that the risks that are relevant to investors “are not reflected in water utilities’ stock performances, and therefore regulated water utilities should have these risks, or the lack thereof, reflected in their rates of return.” (A.06-01-005, *Opening Brief of the Division of Ratepayer Advocates* (filed July 31, 2006), p. 21.)

stock price. However, this is precisely the reason the Commission should not adopt DRA's proposal to discount California American Water's carrying costs for the San Clemente Dam Project. A reduced stock price means that a higher cost of equity must be paid on all rate base, which is one of the impacts that will harm customers and which the Commission should avoid. The fact that the Commission has already subjected some of the San Clemente Dam investment to a carrying cost that is too low does not justify DRA's proposal to set the AFUDC rate significantly below the actual cost of the financing used by California American Water and place California American Water at a higher risk on its investment.

C. **No Party Has Shown that Customers Will Benefit From Setting the San Clemente Dam AFUDC Rate Below the Current Cost of California American Water's Capital.**

Without any evidence that customers will actually benefit, DRA and MPWMD recommend that the Commission discount the carrying cost for the San Clemente Dam Project to avoid the possibility of future rate increases that reflect investment costs. DRA's and MPWMD's proposals are short-sighted and will ultimately harm California American Water and its customers. In its eagerness to prevent rate increases in the short term, DRA is willing to erode California American Water's earnings for the Monterey District, place California American Water at financial risk and ultimately harm customers. Any short-term savings achieved through DRA's and MPWMD's proposal will be far outweighed by the very real harms caused by discounting the carrying costs of the San Clemente Dam Project and creating a disincentive for California American Water to remediate the San Clemente Dam seismic safety issues and make further necessary investments to benefit customers.

Furthermore, DRA's and MPWMD's proposal will lead to higher rates for all California American Water customers. As set forth in the Declaration of David P. Stephenson, DRA's and MPWMD's proposal will leave California American Water with no choice but to restructure its capital structure and pull out debt, leading to higher costs of capital for all customers. This distortion of California American Water's capital structure will impose

additional costs on all California American Water customers, unfairly burdening customers in all of California American Water's districts with higher capital costs.

D. The Commission Must Not Impose a De Facto Disallowance of the Investment Before its Reasonableness Has Been Determined.

The Commission must not impose a de facto disallowance of California American Water's investment by shortchanging the AFUDC return. Under the Commission's standard ratemaking practices, if California American Water cannot book its carrying costs for the San Clemente Dam Project in an AFUDC account, California American Water cannot later recoup such costs. Additionally, if the Commission denies California American Water the opportunity to at least accrue AFUDC at its authorized cost of capital (in lieu of allowing all investments in the San Clemente Dam Project in rate base), it is effectively denying California American Water the opportunity to earn a reasonable return on all of its investments and full recovery of prudent expenses. Practically speaking, such action would be the same as deciding in advance that some of the investment dollars will be disallowed before reasonableness is even considered.

1. DRA's and MPWMD's proposals would deny California American Water the opportunity to earn a compensatory return on its investment, in violation of *Hope* and *Bluefield*.

As set forth in California American Water's Opening Brief, DRA's and MPWMD's proposals would deny California American Water the opportunity to earn a compensatory return on its investment, in violation of *Hope* and *Bluefield*. Under *Hope* and *Bluefield*, California American Water is entitled to the opportunity to earn a return on investment that is "commensurate with returns on investments in other enterprises having corresponding risks."¹⁵ For the reasons discussed above, the actual carrying costs of the San Clemente Dam Project will be higher than California American Water's authorized cost of capital. MPWMD and DRA fail to show that their proposed 90-day commercial paper rate, which will only allow California American Water the opportunity to recover a fraction of its actual carrying costs

¹⁵ *Hope, supra*, 320 U.S. at 603.

related to the San Clemente Dam Project, will not deprive California American Water of the opportunity to earn a reasonable rate of return. At the end of the day, the financial impact on the utility is the same whether investment dollars are disallowed or an inadequate return ordered in advance – in either case, the total funds ultimately available are less than required to support the investment. However, reasonableness review contains the due process protection that the completed project's merits be fully examined before deciding whether some investment should be disallowed. The other parties in this proceeding propose to accomplish the same in advance, through indirect and unfair means.

In an attempt to show that the Commission should deviate from its standard ratemaking practices, MPWMD attempts to distinguish the San Clemente Dam expenses as so-called “predecessor costs” from preconstruction costs.¹⁶ This distinction makes no sense, particularly when California American Water's investments in the Project are no different than preconstruction costs, the San Clemente Dam Project is already in use and useful and customers are already benefiting from California American Water's expenditures improvements. In any event, California American Water's expenditures on the San Clemente Dam Project are paid for with the same money as are construction costs, and should be treated no differently.

2. The reasonableness of the San Clemente Dam Project costs will be addressed during the Commission's reasonableness review and is irrelevant to the Commission's calculation of the AFUDC rate in this proceeding.

Contrary to DRA's and MPWMD's claims, the Commission must not reduce the AFUDC rate because of the risk that customers may not receive the benefits of expenditures on the San Clemente Dam Project. In keeping with the Commission's normal ratemaking, the recovery of those costs will be addressed during the Commission's reasonableness review at a later date; arguments about their merits or alleged risks are thus premature and irrelevant to the Commission's calculation of the AFUDC rate in this proceeding. The carrying costs simply are

¹⁶ MPWMD Brief, p. 6.

what they are, despite MPWMD's and DRA's contentions about the reasonableness of the Project. California American Water is only preserving the opportunity to earn a compensatory rate of return in this proceeding and is not seeking authority to increase customer rates in this proceeding.

Contrary to MPWMD's contentions, California American Water customers are not being converted into "guarantors" of the San Clemente Dam Project – a term of no real meaning in this context. MPWMD contends that setting the AFUDC rate at the weighted average cost of capital would unfairly shift the risk of the San Clemente Dam Project from shareholders to customers by requiring customers to pay for the costs of an uncertain project. MPWMD's contention is misplaced. As mentioned above, the ultimate recovery of AFUDC interest will be subject to the Commission's review of the reasonableness of the investment, with the participation of these parties. Carrying costs for disallowed investment dollars will themselves also be disallowed, so customers will not be required to fund anything the Commission finds unreasonable or imprudent. The balance of risks between customers and shareholders is therefore no different than for any other utility investment under normal ratemaking.

Furthermore, DRA's and MPWMD's assertion that customers should bear none of the risk of major capital projects and that utility shareholders should bear all of the risk is wholly inconsistent with positions taken by DRA in the Commission's gain on sale proceeding (R.04-09-003). In that proceeding, DRA has taken the position that customers assumed the risk of the investment, and thus, they should be assigned the gain on sale. DRA's position generally conflicts with the Commission's own finding that customers bear most of the risk associated with utility property.¹⁷ Basic principles of finance and ratemaking are more useful guides to the current question than DRA's contradictory pronouncements on risk.

¹⁷ See e.g., D.06-05-041, *Order Instituting Rulemaking on the Commission's Own Motion for the Purpose of Considering Policies and Guidelines Regarding the Allocation of Gains From Sale of Energy, Telecommunications, and Water Utility Assets*, 2006 Cal.PUC LEXIS 291, *1.

3. The Commission should give no weight to MPWMD's and DRA's mischaracterizations of the San Clemente Dam Project.

In their attempt to persuade the Commission that the AFUDC rate should be discounted below California American Water's authorized cost of capital, DRA and MPWMD make numerous irrelevant and false accusations regarding the San Clemente Dam Project. MPWMD wastes much of its Brief grossly mischaracterizing the status of the project and California American Water's efforts to responsibly pursue a project. Although these allegations are largely irrelevant to this proceeding, California American Water takes this opportunity to address some of the mischaracterizations of the Project contained in MPWMD's and DRA's Briefs.

First, there is no uncertainty that California American Water must remediate the San Clemente Dam to prevent the failure of the dam during extreme loading conditions. California American Water is undertaking this project under the orders of the Division of Safety of Dams ("DSOD") to remediate the seismic safety issues. California American Water's remediation of the San Clemente Dam Project is not optional.

Second, California American Water has been acting responsibly to comply with the government mandates and addresses seismic, hydrological, environmental and other issues related to the San Clemente Dam Project. While the reasonableness of its costs are not at issue in this proceeding, California American Water reminds this Commission that California American Water inherited the seismic safety issues associated with the San Clemente Dam when it acquired properties from California Water and Telephone Company in 1966. At the time the Dam was constructed, during the height of the silent movie era, very little was known about building for earthquake safety.

As set forth in the Declaration of F. Mark Schubert in Support of California American Water's Opening Brief, the delays in the environmental review process are outside of the control of California American Water. California American Water takes issue with MPWMD's characterization of the delay in the environmental review of the San Clemente Dam Project. MPWMD contends that California American Water has caused the delay in the

permitting process due to its alleged “opposition to alternatives other than buttressing the existing structure.” There is no merit to MPWMD’s contentions. California American Water has diligently pursued a solution to address the seismic safety issues and prevent the failure of the Dam. MPWMD has done nothing to help move that process forward.

Third, contrary to MPWMD’s contentions, the fact that there are four alternatives to the dam strengthening option does not make the Project uncertain. MPWMD wrongly contends that there is “no actual project in sight.”¹⁸ The EIR/EIS, which is expected to be finalized and certified in short order, analyzes four alternatives to the dam strengthening option, including dam notching, dam removal, river bypass and no project. The certified EIR/EIS will adopt one of these projects. MPWMD makes much ado about the fact that there is no guarantee that California American Water will receive a Certificate of Public Convenience and Necessity (CPCN) to construct the Project. No CPCN is required for the Project.¹⁹ MPWMD’s contentions regarding the uncertainty of the San Clemente Dam Project are unfounded.

II. THE COMMISSION’S CASE LAW SUPPORTS CALIFORNIA AMERICAN WATER’S REQUESTED AFUDC RATE

Contrary to DRA’s and MPWMD’s contentions, the Commission does not have an existing policy for the AFUDC cost of capital that applies to water utility investments. It is for this reason that California American Water was directed to file the application at issue in this proceeding. Prior decisions allowing water utilities to accrue capitalized interest based upon a short-term borrowing rate for short-term deferred items are not applicable to the San Clemente Dam Project because the project financing is neither short-term nor low risk. Although the issue of what AFUDC rate the Commission should apply to water utilities’ long-term, major capital projects is a novel issue, California American Water’s proposal to set the San Clemente Dam

¹⁸ MPWMD Brief, p. 5.

¹⁹ California Public Utilities Code §1001.

Project AFUDC rate at its currently authorized cost of capital is rooted in Commission precedent and Commission caselaw supports its approval.

A. **Commission Precedent on the Ratemaking Treatment of Short-Term Water Investments is Inapposite Here**

DRA and MPWMD attempt to argue that California American Water's AFUDC rate should be governed by selected prior decisions allowing water utilities to accrue capitalized interest based upon a **short-term borrowing rate for short-term deferred items**. DRA and MPWMD would prefer to ignore the Commission's finding in D.06-11-050 that the San Clemente Dam Project is neither a short-term nor a low-risk project that typically accrues AFUDC by water utilities.²⁰ Despite the fact that the decisions cited by DRA and MPWMD were all available to the Commission when it ordered California American Water to initiate this proceeding, DRA and MPWMD repeat their same tired arguments that these decisions somehow require the Commission to apply the short-term interest rate to the San Clemente Dam Project. If those parties were correct, this proceeding would not exist. As discussed below, the particular decisions cited by DRA and MPWMD are inapposite here.

First, DRA's reliance upon three decisions (D.93-10-038, D.96-12-005, D.00-03-053) in which the Commission adopted an AFUDC rate through settlement is in direct conflict with this Commission's long-standing policy of encouraging settlements and not using a settled position from a prior case for or against any party in a future proceeding.²¹ Because these settled rates were agreed upon through settlement negotiations between DRA and California American

²⁰ D.06-11-050, *In re Application of California-American Water Company (U 210 W) for an order authorizing it to increase its rates for water service in its Monterey District*, 2006 Cal. PUC LEXIS 479, *67 (2006) ("D.06-11-050, 2006 Cal. PUC LEXIS 479"), **65, 66.

²¹ D.93-10-038, *In re Application of California-American Water Company (U 210 W) for an order authorizing it to increase its rates for water service in its Monterey District*, 1993 Cal. PUC LEXIS 775 (1993); D.96-12-005, *In re Application of California-American Water Company for an order authorizing it to increase its rates for water service in its Monterey Division*, 1996 Cal. PUC LEXIS 1066 (1996); D.00-03-053, *In re Application of the California-American Water Company (U210W) for an Order Authorizing it to Increase its Rates for Water Service in its Monterey Division*, 2000 Cal. PUC LEXIS 229 (2000).

Water in a prior rate case, it cannot serve as justification or precedent for adopting DRA's position in this case.

Second, DRA's reliance on the Risk Order Instituting Investigation (OII) issued nearly seventeen years ago is also misplaced.²² DRA broadly contends that this decision established a policy that should apply to all projects undertaken by water utilities. However, at the time the Risk OII was issued, the water projects in question were short-term and low risk. As set forth in California American Water's Opening Brief, neither the Commission nor the parties to the Risk OII contemplated a project the size and magnitude of the San Clemente Dam Project. Long-term capital projects such as the San Clemente Dam are significantly more costly and risky than the short-term projects historically undertaken by water utilities.²³

Third, DRA wrongly contends that D.03-09-022, the decision addressing the ratemaking treatment of the Coastal Water Project, established a policy applicable to all water utility projects.²⁴ By its own admission, DRA recognizes that the decision distinguishes the Coastal Water Project from typical water utility construction projects.²⁵ DRA next argues that the Commission's determination regarding the ratemaking treatment for the Coastal Water Project in D.03-09-022 should be applied here because of the similarities between the Coastal Water Project and the San Clemente Dam Project. However, there are key differences between the Coastal Water Project and the San Clemente Dam Project. As such, there is no merit to

²² D.94-06-033, *Investigation on the Commission's Own Motion into the Financial And Operational Risks of Commission Regulated Water Utilities, and Whether Current Ratemaking Procedures and Policies Require Revisions*, 1994 Cal. PUC LEXIS 428 (1994).

²³ See California American Water Opening Brief, pp. 17-18.

²⁴ D.03-09-022, *In re Application of California-American Water Company (U 210 W) for a Certificate that the Present and Future Public Convenience and Necessity Requires Applicant to Construct and Operate the 24,000 acre foot Carmel River Dam and Reservoir in its Monterey Division and to Recover All Present and Future Costs in Connection Therewith in Rates*, 1997 Cal. PUC LEXIS 1279.

²⁵ DRA Brief, p. 9.

MPWMD's contention that the Commission must adopt the same outcome for the San Clemente Dam Project as it did for the Coastal Water Project.

As the Commission has already recognized, the San Clemente Dam Project is a long-term, major capital project that may take a number of years before it becomes fully operational.²⁶ California American Water does not have a choice in whether it will remedy the seismic risk of the San Clemente Dam. In contrast, California American Water may ultimately choose not to pursue the Coastal Water Project. For example, there are numerous scenarios for the Coastal Water Project in which a regional project could unfold, ranging from a public/private partnership for a regional project to the subsequent addition of components over time to the Company's Coastal Water Project by participating government agencies to increase capacity to serve other parts of the Monterey area.

Additionally, the Commission has already authorized California American Water to collect customer contributions for the Coastal Water Project, through Special Request No. 1 Surcharge, which help offset the costs of the project and alleviate cash flow issues and reduce carrying costs.²⁷ No such customer surcharge mechanism has been authorized for the San Clemente Dam Project. Thus, to give California American Water the opportunity to be made whole for the overall cost of the San Clemente Dam Project investment (subject to reasonableness review), the Commission should authorize California American Water to capitalize its AFUDC at its authorized cost of capital.

²⁶ The Commission in D.06-11-050 clearly articulated that it might be more appropriate to use California American Water's long-term debt and equity in calculating the AFUDC interest rate because of the long-term nature of the Project financing. (D.06-11-050, 2006 Cal. PUC LEXIS 479, *67 (stating that "We find this calculation may be more appropriate here as Cal-Am will need to obtain financing over several years for this project.")).

²⁷ D.06-12-040, *In re Application of California-American Water Company for a Certificate of Public Convenience and Necessity to Construct and Operate its Coastal Water Project to Resolve the Long-Term Water Supply Deficit in its Monterey District and to Recover All Present and Future Costs in Connection Therewith in Rates*, 2006 Cal. PUC LEXIS 422 (2006), **15-17.

B. Commission Precedent Authorizes Energy Utilities to Accrue AFUDC at Rates that Reflect the Actual Source of Funds Used to Finance the Project

California American Water has demonstrated that its requested AFUDC rate is consistent with precedent in which the Commission has authorized energy utilities to accrue AFUDC for major long-term capital projects at rates that reflect the source of funds used to finance the project.²⁸ The decisions cited in MPWMD's and DRA's own Briefs demonstrate that the Commission generally authorizes energy utilities to recover an AFUDC rate that reflects long-term debt and equity (e.g., D.05-02-052, D.06-05-016 and D.84-08-125). DRA and MPWMD attempt to argue that California American Water's requested AFUDC rate is distinguishable from these cases. As discussed below, DRA's and MPWMD's arguments are unpersuasive and contradicted by the very cases they cite.

MPWMD also challenges, without any coherent explanation, the Commission's finding in D.06-11-050 that "the Commission generally uses an AFUDC interest rate that also reflects long-term debt and equity" for energy projects.²⁹ The clearest proof that the Commission's AFUDC methodology is based upon the expected sources used to finance the project is found in the Commission's acceptance of Federal Energy Regulatory Commission (FERC) Order 561. The Commission has generally accepted the FERC formulae in Order 561 for the computation of the AFUDC rate, which include the "recognition of the embedded long-term debt interest rate including restricted debt issues, the last authorized return on equity, the preferred stock cost rate, the short-term debt interest rate, and the average balance of CWIP."³⁰

²⁸ *Id.* at 67 (recognizing that "for energy projects, the Commission generally uses an AFUDC interest rate that also reflects long-term debt and equity. We find this calculation may be more appropriate here as Cal-Am will need to obtain financing over several years for the project.").

²⁹ D.06-11-050, 2006 Cal. PUC LEXIS 479, *67.

³⁰ See D.84-08-125, *In re Application of San Diego Gas & Electric Company for authority to include the Southwest Powerlink as a specified major addition under its Major Additions Adjustment Clause (MAAC) and to increase its Major Additions Adjustment Billing Factor (MAABF) and decrease its Annual Major Additions Rate (AMAR) upon operation of the Southwest Powerlink*, 1984 Cal. PUC LEXIS 1309, **12-13 (1984) ("D.84-08-125, 1984 Cal. PUC LEXIS 1309").

The Commission has declared that the “basic concept underlying the AFUDC rate formulae [is to provide] a return on investment based on the utility’s capital structure similar to the overall rate of return derivation.”³¹ Short-term debt, which is not regularly included as part of a utility’s capital structure for purposes of the overall rate of return derivation, should only be included in the AFUDC calculation to the extent it is available to finance a specific project.³² California American Water has provided affirmative evidence that its short-term debt is used for working capital needs and not for financing long-term capital required for its major capital investments such as the San Clemente Dam Project.

As discussed below, the decisions cited in MPWMD’s and DRA’s own Briefs demonstrate that the Commission has recognized the importance of setting an AFUDC rate that reflects the specific carrying costs of the project.³³

First, the Commission’s recent authorization of Pacific Gas & Electric’s (PG&E) AFUDC rate at its authorized cost of capital for the Diablo Canyon steam generator replacement program in D.05-02-052 directly supports California American Water’s requested AFUDC rate.³⁴ Similar to the San Clemente Dam Project, PG&E had not yet completed the California Environmental Quality Act (CEQA) environmental review for the nuclear plant steam generators. As noted by MPWMD, in D.05-02-052 the Commission adopted PG&E’s AFUDC

³¹ D.84-08-125, 1984 Cal. PUC LEXIS 1309, *14.

³² D.06-05-016, *Application of Southern California Edison Company (U 338-E) For Authority to, Among Other Things, Increase Its Authorized Revenues For Electric Service in 2006, and to Reflect That Increase in Rates; Investigation on the Commission’s Own Motion into the Rates, Operations, Practices, Service and Facilities of Southern California Edison Company*, 2006 Cal. PUC LEXIS 189, *320 (2006) (“D.06-05-016, 2006 Cal. PUC LEXIS 189”).

³³ D.84-08-125, 1984 Cal. PUC LEXIS 1309, *15 (stating that “Since the trust fund balances are not available for normal company operations, it is reasonable that the cost of holding such funds for a specific project be charged to that project. It is equally reasonable that income from such trust fund balances be credited to the project.”).

³⁴ D.05-02-052, *Application of Pacific Gas and Electric Company (U 39 E) for Authority to Increase Revenue Requirements to Recover the Costs to Replace Steam Generators in Units 1 and 2 of the Diablo Canyon Power Plant*, 2005 Cal. PUC LEXIS 83 (2005) (“D.05-02-052, 2005 Cal. PUC LEXIS 83”).

rate at its then-authorized cost of capital (9.24 percent), and rejected DRA's proposal to reduce the AFUDC rate because PG&E had subsequently reduced its projected cost of capital in a pending rate case.³⁵

MPWMD attempt to distinguish this case on the mistaken premise that California American Water allegedly does not have to undertake the San Clemente Dam Project whereas the steam generator replacements were a necessary project.³⁶ However, there is no question that the San Clemente Dam remediation Project is necessary and must be completed. Similarly, MPWMD's attempt to distinguish the San Clemente Dam as allegedly more controversial than nuclear plant steam generators is meritless.

MPWMD also contends that D.05-02-052 is distinguishable because PG&E had completed a cost-effective study and the Commission authorized PG&E to recover up to \$706 million, possibly without an after-the-fact reasonableness review. Certainly, if the Commission can make the extraordinary decision to pre-approve PG&E's expenditures up to \$706 million without an after-the-fact reasonableness review if PG&E's expenditures did not exceed this amount, then the Commission can be assured that the Commission can authorize the AFUDC rate at California American Water's authorized cost of capital when such costs will be subject to reasonableness review.

Second, D.84-08-125 affirms the Commission's policy to adopt an AFUDC rate that reflects the financing costs of a particular project, as California American Water is seeking here. In D.84-08-125, the Commission utilized the formula in FERC Order 561 to determine the AFUDC rate to compensate San Diego Gas & Electric Company (SDG&E) for the financing of its Southwest Powerlink, a 24-mile transmission line to provide an alternate transmission path while its existing circuits were being modified. Because SDG&E derived approximately 39

³⁵ D.05-02-052, 2005 Cal. PUC LEXIS 83, **15-19.

³⁶ *Id.* at *2 (stating that the review of the steam generator replacement program pursuant to CEQA is currently in progress).

percent of the Southwest Powerlink financing from the sale of short-term bonds the Commission appropriately reduced the total AFUDC recovered by SDG&E to reflect the cost savings achieved through these low-interest rate bonds that were sold for the project.

DRA contends that the methodology applied to SDG&E in D.84-08-125 would render a lower AFUDC rate for the San Clemente Dam Project than California American Water's authorized cost of capital.³⁷ This is incorrect. It is critical to emphasize that, unlike the financing for SDG&E's Southwest Powerlink, California American Water does not have access to special low-interest bonds, much less short-term debt, to finance the San Clemente Dam Project. As such, the Commission should give no weight to DRA's proposal to lower California American Water's AFUDC rate simply because SDG&E had access to unique low-cost bonds for the financing of its Southwest Powerlink project. Indeed, this case cuts against DRA's position because it illustrates a careful focus by the Commission on the actual sources of funding needed to support a project.

MPWMD attempts unpersuasively to distinguish D.84-08-125 from this proceeding by arguing that SDG&E had already been granted a CPCN and commenced construction. As an initial matter, no CPCN is required for the San Clemente Dam Project. Furthermore, the Commission's decision to authorize SDG&E to capitalize its AFUDC is based upon the company's request for AFUDC treatment beginning when Powerlink's operations commenced.³⁸

Third, D.06-05-016 supports the notion that the Commission should not include short-term debt in California American Water's AFUDC rate calculation if it is not available for financing investments such as the San Clemente Dam Project. In D.06-05-016, the Commission found that only a minimal amount of short-term debt was available for construction activities due to other obligations for those funds, including the large amounts necessary to cover balancing

³⁷ DRA Brief, p. 11.

³⁸ D.84-08-125, 1984 Cal. PUC LEXIS 1309, *6.

account under-collections and fuel inventory.³⁹ The Commission included only a tiny fraction of Southern California Edison's (SCE) short-term debt instead of assigning a zero value for short-term debt in its AFUDC rate calculation.⁴⁰ The Commission included only the minuscule portion of SCE's short-term debt that it determined could be used to finance construction activities, which amounted to less than one percent of SCE's total capitalization.⁴¹

Fourth, D.84-05-013 affirms that California American Water should be allowed the opportunity to accrue AFUDC at its authorized cost of capital in lieu of earning its authorized return on and of the San Clemente Dam Project.⁴² DRA mistakenly contends that the Commission determined in D.84-05-013 that the 90-day commercial paper rate is an appropriate AFUDC interest rate for the modifications needed to restart the San Onofre Nuclear Generating Station Unit 1 (SONGS 1). Nowhere in that decision does the Commission find that the Respondents SCE and San Diego Gas & Electric (SDG&E) should accrue AFUDC rate at the 90-day commercial paper rate or that the "lower AFUDC rate" refers to the 90-day commercial paper rate. In fact, the Commission expressly rejected The Utility Reform Network's (TURN) proposal in that proceeding, which would require the Respondents to remove all costs associated with SONGS 1 from rate base and place such costs in a memorandum account without accruing AFUDC. The Commission found that TURN's proposal would be unfair to the Respondents' shareholders, would be unnecessary to protect customers, and "would remove any incentive for

³⁹ D.06-05-016, 2006 Cal. PUC LEXIS 189, **320, 543, Finding of Fact ¶136.

⁴⁰ *Id.* at 320.

⁴¹ See D.06-05-016, 2006 Cal. PUC LEXIS 189, **319-20 (noting that DRA proposed to include approximately \$300 million in short-term debt, which amounted to 2.6 percent of the total capitalization, in forecasting the AFUDC rate). The Commission included \$43 million of SCE's short-term debt in the AFUDC rate calculations.

⁴² D.84-05-013, *Investigation on the Commission's own motion to determine whether San Onofre Nuclear Generating Station Unit 1 should be ordered removed from the rate base of Southern California Edison Company and San Diego Gas & Electric Company*, 1984 Cal. PUC LEXIS 317 (1984) ("D.84-05-013, 1984 Cal. PUC LEXIS 317").

respondents to return SONGS 1 to full operation and, thus, may prematurely remove an economic resource beneficial to California electric consumers.”⁴³

DRA appears to misunderstand or simply ignore that in D.84-05-013 the Respondents were provided two alternatives: (1) remove SONGS 1 from rate base, place current capital costs in a separate deferred debit account and earn the utility’s **authorized** AFUDC rate; or (2) continue to book SONGS1 capital costs and earn on such capital costs at the utility’s authorized rate of return, subject to refund if SONGS1 was not operating by a date certain. If anything, this decision supports California American Water accruing its rate of return on the San Clemente Dam investment, particularly in light of the fact that the San Clemente Dam remains in use and is useful and is not currently earning a rate of return on this investment.

DRA contends that the Commission’s ratemaking treatment for energy utilities is of questionable value for determining the AFUDC methodology for the San Clemente Dam Project due to differences in the energy and water industries. Regardless of any perceived differences between the energy and water industries, the Commission in D.06-11-050 clearly articulated that the San Clemente Dam Project is similar to the long-term projects undertaken by energy utilities and that that it might be more appropriate to use California American Water’s long-term debt and equity to determine the appropriate AFUDC rate, as it has provided to the energy utilities.⁴⁴ The Commission should look to the ratemaking treatment used for energy utilities as it has done previously in developing the ratemaking treatment applied to water utilities.⁴⁵

⁴³ D.84-05-013, 1984 Cal. PUC LEXIS 317, **42-43.

⁴⁴ D.06-11-050, 2006 Cal. PUC LEXIS 479, *67.

⁴⁵ See e.g., D.06-11-050, 2006 Cal. PUC LEXIS 479, *66 (noting that the Construction Work in Progress policy “articulated in D.03-09-002 is consistent with our policies for energy utilities.”).

C. **The Commission's Ratemaking Treatment of Telecommunications Utilities under the New Regulatory Framework is Irrelevant for Determining the AFUDC Rate for the San Clemente Dam Project.**

DRA's and MPWMD's reliance upon D.04-09-061, which is an investigation the Commission conducted as part of its oversight of the telecommunications "New Regulatory Framework" (NRF), is misplaced. In particular, the purpose of the audit in D.04-09-061 was to determine whether the earnings of Pacific Bell Telephone Company and Verizon California Incorporated had reached a threshold that would require earnings sharing.⁴⁶ The Commission's NRF, which had been in place for nearly fifteen years at the time of this decision, is not a traditional rate-of-return regulatory framework and provides no risk of rate base disallowance. As such, the Commission should give no weight to DRA's and MPWMD's contentions that the Commission's ratemaking treatment of telecommunications utilities is relevant here.

III. **THE WATER ACTION PLAN SUPPORTS ALLOWING WATER UTILITIES THE OPPORTUNITY TO RECOVER THE FULL COST OF WATER INFRASTRUCTURE INVESTMENTS.**

Consistent with the Commission's policy objectives in the Water Action Plan to support water infrastructure investments, the Commission should support California American Water's efforts to address risk to life and property from seismic hazards. The Commission should also support the safety-related actions of other governmental authorities, including the mandate of the DSOD, by allowing California American Water compensatory costs for the San Clemente Dam Project development and construction. DRA's and MPWMD's contention that the Water Action Plan does not support the San Clemente Dam Project because it is a safety project rather than a water infrastructure investment is erroneous and shortsighted.

DRA and MPWMD absurdly argue that the Commission should not encourage an investment that is necessary to protect public safety if it will not result in direct improvements to the quality of California American Water's water or create additional water supply. DRA's and

⁴⁶ D.04-09-061, *Order Instituting Rulemaking on the Commission's Own Motion to Assess and Revise the New Regulatory Framework for Pacific Bell and Verizon California Incorporated*; *Order Instituting Investigation on the Commission's Own Motion to Assess and Revise the New Regulatory Framework for Pacific Bell and Verizon California Incorporated* (2004).

MPWMD's arguments ring hollow. The Commission's Water Action Plan policy objective of encouraging water utilities to invest in necessary infrastructure has nowhere been limited to improving the quality of water on increasing the water supply. Rather, the Commission's Water Action Plan recognizes the importance of adopting policies that promote infrastructure investment and enable water utilities to undertake necessary capital projects without creating financial hardship.

IV. CONCLUSION

For all of the foregoing reasons, and for the reasons set forth in its Opening Brief, California American Water urges the Commission to authorize it to set its AFUDC on its San Clemente Dam Memorandum Account at its current authorized rate of return.

Dated: September 28, 2007

STEEFEL, LEVITT & WEISS
A Professional Corporation

By: /s/ Sarah E. Leeper
Sarah E. Leeper

Attorneys for Applicant
California-American Water Company

EXHIBIT A

DECLARATION OF F. MARK SCHUBERT, P.E. IN SUPPORT OF CALIFORNIA-AMERICAN WATER COMPANY'S CONCLUDING BRIEF

**BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA**

Application of California-American Water
Company (U 210 W) for an Interest Rate of
8.33% for Allowance for Funds Used
During Construction (AFUDC) for its San
Clemente Dam Memorandum Account.

Application No. 07-02-023
(Filed February 20, 2007)

**DECLARATION OF F. MARK SCHUBERT, P.E. IN SUPPORT OF CALIFORNIA-
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Date: September 28, 2007

**BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA**

Application of California-American Water Company (U 210 W) for an Interest Rate of 8.33% for Allowance for Funds Used During Construction (AFUDC) for its San Clemente Dam Memorandum Account.

Application No. 07-02-023
(Filed February 20, 2007)

DECLARATION OF F. MARK SCHUBERT, P.E. IN SUPPORT OF CALIFORNIA-AMERICAN WATER COMPANY'S CONCLUDING BRIEF

I, F. Mark Schubert, declare:

1. I am the Director of Engineering for the Western Region of the American Water Works Service Company ("American Water"). The Western Region is comprised of water and wastewater utility subsidiaries located in Arizona, California, Hawaii, New Mexico and Texas, including California American Water. My business address is 303 H Street, Suite 250, Chula Vista, CA 91910.

2. Information regarding my employment and qualifications is included in my declaration in support of California American Water's Opening Brief, filed in this proceeding. This information has not changed.

3. I make this Declaration in support of California-American Water Company's Concluding Brief ("Concluding Brief"). The purpose of my declaration is to respond to Monterey Peninsula Water Management District (MPWMD) and Division of Ratepayer Advocates' (DRA) contentions that customers have benefited little, if any, from California American Water's improvements to the San Clemente Dam Project. In particular, this Declaration describes California American Water's improvements to the San Clemente Dam, which are currently in use and useful and benefiting customers. These improvements include drawdown system components (port construction, aerators, fish rescue, frog rescue, fish passageway construction, etc.) and the development and implementation of the emergency action

plan's components (design, construction and equipment). California American Water undertook these improvements to institute interim safety measures at the San Clemente Dam as ordered by the California Department of Water Resources, Division of Safety of Dams' (DSOD), in order to reduce the level of water in the reservoir through an annual drawdown and to mitigate the impacts to the California red-legged frog and steelhead trout occupying the reservoir during the annual drawdown. The current estimate of total expenditures by California American Water on these improvements is approximately \$3.5 million dollars, which only reflects work performed by California American Water beginning in mid-2002 and up through the first quarter of 2007.

4. In 2003, California American Water drilled six 12-inch diameter ports, or holes, through the dam itself in order to allow a seasonal drawdown of the reservoir of 10 feet, to an elevation of approximately 515 feet during low flow periods. The drawdown is timed to allow migratory fish passage. Each port was equipped with a trash rack to prevent large debris from entering and blocking flow through the port. These seasonal drawdowns have occurred every year, with the accompanying need to adequately ensure the environmental requirements for proper care of the California red-legged frog and steelhead trout are met.

5. In 2004, California American Water installed a downstream fish passage system to allow fish to exit the reservoir. The system consists of a borehole through the dam (at the 515 foot elevation), which connects a slide gate on the reservoir side of the dam to a 14-inch diameter pipe on the downstream side of the dam. The 14-inch diameter polyvinyl chloride (PVC) pipe runs parallel to the fish ladder, and eventually discharges into the eighth pool of the fish ladder at an elevation of approximately 513 feet. There is an adjustable weir located on the upstream side of the dam, which provides surface spill into a box that then flows into the adjoining bypass system.

6. In addition, California American Water developed an Emergency Action Plan in 2003, in coordination with the Carmel Valley Fire Department and the Monterey County Office of Emergency Services. Under this program, the Dam is monitored by an instrumentation system that automatically collects information about the Dam and river conditions, which in turn

transmits it to the Carmel Valley Emergency Operations Center and to the California American Water's Operations Center. There are audible alarms that will indicate situations that require immediate attention. Finally, the instrumentation will monitor seismic activity at the Dam, water levels at the reservoir, the level of the downstream plunge pool, and at the Old Carmel River Dam Bridge.

7. Finally, California American Water undertook numerous studies of the dam strengthening option and alternatives analyzed in the Draft Environmental Impact Report/Environmental Impact Statement. These studies include extensive sediment transport modeling and seismic safety design and environmental analyses. These and other improvements at the San Clemente Dam as set forth in this declaration are already benefiting customers. In addition, the San Clemente Dam continues to be used and useful as a diversion point and as an emergency backup resource to ensure system reliability.

I declare under penalty of perjury under the laws of the state of California that the foregoing is true and correct to the best of my knowledge and belief. Executed this 28th day of September, 2007, at Monterey, California.



F. Mark Schubert, P.E.

EXHIBIT B

DECLARATION OF DAVID P. STEPHENSON IN SUPPORT OF CALIFORNIA-AMERICAN WATER COMPANY'S CONCLUDING BRIEF

**BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA**

Application of California-American Water
Company (U 210 W) for an Interest Rate of
8.33% for Allowance for Funds Used
During Construction (AFUDC) for its San
Clemente Dam Memorandum Account.

Application No. 07-02-023
(Filed February 20, 2007)

**DECLARATION OF DAVID P. STEPHENSON IN SUPPORT OF CALIFORNIA-
AMERICAN WATER COMPANY'S CONCLUDING BRIEF**

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Attorneys for Applicant
California-American Water Company

Date: September 28, 2007

BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF CALIFORNIA

Application of California-American Water Company (U 210 W) for an Interest Rate of 8.33% for Allowance for Funds Used During Construction (AFUDC) for its San Clemente Dam Memorandum Account.

Application No. 07-02-023
(Filed February 20, 2007)

DECLARATION OF DAVID P. STEPHENSON IN SUPPORT OF CALIFORNIA-AMERICAN WATER COMPANY'S CONCLUDING BRIEF

I, David P. Stephenson, declare:

1. I am employed by California-American Water Company as the Manager of Rate Regulation, and my business address is 4701 Beloit Drive, Sacramento, CA 95838.

2. Information regarding my employment and qualifications is included in my declaration in support of California American Water's Opening Brief, filed in this proceeding. This information has not changed.

3. The purpose of this declaration is to respond to certain factual contentions made by the Division of Ratepayer Advocates (DRA) and Monterey Peninsula Water Management District (MPWMD) in their Reply Briefs, filed on September 7, 2007.

4. The proposal submitted by DRA and MPWMD would set the allowance for funds used during construction (AFUDC) rate significantly below the actual cost of the financing the San Clemente Dam Project used by California American Water. My declaration in support of California American Water's Opening Brief sets forth reasons why California American Water's actual carrying costs for the San Clemente Dam Project will be significantly higher than the 90-day commercial paper rate. In addition, this declaration provides additional bases for my opinion that short-term debt will be inadequate to fund the San Clemente Dam Project and that setting the AFUDC rate below California American Water's authorized cost of capital will have a negative impact on California American Water customers.

5. California American Water has a capital investment program that averages about \$120,000,000 annually from 2008 through 2012, including such major projects as the Coastal Water Project in Monterey, retrofitting of the San Clemente Dam in Monterey and installation of meters in Sacramento. California American Water will need to issue additional debt and equity to finance all of these capital needs, including the San Clemente Dam Project. Any short-term debt that is used as an interim measure to finance capital projects will be refinanced annually with long-term debt and equity. As such, California American Water's authorized cost of capital is the only reasonable approximation of the carrying costs for the San Clemente Dam Project.

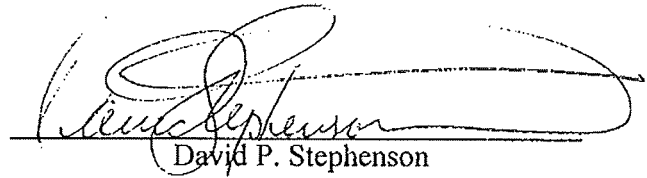
6. California American Water's current average annual short-term financing is used almost exclusively to cover memorandum accounts, balancing accounts, other deferred items and California American Water's other operating costs. As such, no short-term debt will be used to fund any portion of the San Clemente Dam Project. In fact, because of the large balances that California American Water carries in its balancing accounts, memorandum accounts and other deferred items, including the Coastal Water Project balancing account, which is currently over \$10,000,000, it is highly likely that average annual short-term borrowings will not even fully cover these items, let alone necessary capital expenditures.

7. I am concerned that if the Commission accepts DRA's and MPWMD's proposal to deny California American Water the opportunity to at least accrue AFUDC at its authorized cost of capital, the Commission will deprive the company of its opportunity to earn a reasonable return on the San Clemente Dam Project, an investment California American Water is being required to make due to governmental mandates.

8. In addition to harming California American Water's financial condition, shortchanging the carrying cost of the San Clemente Dam Project will severely impact all current customers served by California American Water. It will leave California American Water with little choice but to restate its debt and equity structure for rate-making purposes, thereby reducing the debt component and increasing the equity component for rate-making purposes. As a result of the restatement the equity component will exceed the debt component, causing the

pre-tax cost of capital to increase as much as 80 basis points. This will lead to higher costs of capital for all California American Water customers.

I declare under penalty of perjury under the laws of the state of California that the foregoing is true and correct to the best of my knowledge and belief. Executed this 28th day of September, 2007, at Sacramento, California.



David P. Stephenson

PROOF OF SERVICE

I, Michelle Chavez, declare as follows:

I am employed in the City and County of San Francisco, California. I am over the age of eighteen years, and not a party to the within cause; my business address is STEEFEL, LEVITT & WEISS, One Embarcadero Center, 30th Floor, San Francisco, California 94111-3719. On September 28, 2007, I served the within:

California-American Water Company's Concluding Brief

on the interested parties in this action by placing a true copy thereof in a sealed envelope, addressed as follows:

Please see attached Service List



(BY PUC E-MAIL SERVICE) By transmitting such document electronically from Steefel, Levitt & Weiss, San Francisco, California, to the electronic mail addresses listed above. I am readily familiar with the practice of Steefel, Levitt & Weiss for transmitting documents by electronic mail, said practice being that in the ordinary course of business, such electronic mail is transmitted immediately after such document has been tendered for filing. Said practice also complies with Rule 1.10(b) of the Public Utilities Commission of the State of California and all protocols described therein.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct and that this declaration was executed on September 28, 2007 at San Francisco, California.

/s/Michelle Chavez

Michelle Chavez

VIA PUC E-MAIL SERVICE:

(LAST UPDATED MAY 16, 2007)

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